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THE POLITICAL REPERCUSSIONS OF THE DEBT CRISIS IN MAJOR LDCs

Volume I—Key Judgments

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SCOPE NOTE

This Estimate examines some of the political repercussions of the debt crisis in the developing countries. It focuses on seven countries—Argentina, Brazil, Chile, Mexico, Nigeria, the Philippines, and Venezuela—whose debt to banks is large enough to constitute a potential threat to the stability of the international financial system and the servicing of which has created serious economic problems. Countries whose debt problems may be serious but not threatening to the system, such as Bolivia, are discussed only briefly. Countries that have been able to manage large debts without severe economic difficulties, such as South Korea, are not discussed.

The Estimate assesses the likely impact of debt-related economic austerity on political stability and policies in the debtor countries. It focuses particularly on whether and how much these political repercussions will constrain the ability of debtor-country governments to maintain economic adjustment policies and deal with their creditors.

For purposes of this paper we define political instability as that which causes radical changes in a government's policy or in the government itself.

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KEY JUDGMENTS

The severe economic repercussions of the debt problem in the major LDC debtors—declines of some 10 percent in GNP, of 15 to 20 percent in per capita real incomes, and of 40 to 60 percent in imports—have not yet caused serious political instability or basic changes in policy orientation for the governments of these less developed countries. But economic problems have generated political pressures that are substantially restricting the flexibility of these governments to undertake economic reforms and to deal cooperatively with foreign creditors, including the IMF.

If economic recovery proceeds in the next year or two, then debtor-creditor differences can probably be worked out through ad hoc adjustments by both sides. In the less likely case that economic recovery in the debtor countries is prevented by highly adverse external economic developments—stagnant or closed markets, higher interest rates, or reduced net capital inflows—the chances are that there would be defaults, severe financial disruptions, and major changes in the management of international debt.

Even if external economic conditions are reasonably favorable, many debtor countries will face continued economic austerity for many years in order to service their debt. These conditions will make political conflicts more difficult to resolve and could thereby contribute to major political upsets, such as a return to military rule in Argentina, the fragmentation of political power in Mexico, and the growth of leftwing violence in Chile and the Philippines.

Perhaps the key determinants of political reaction to prolonged austerity are how much populations expect of governments and the flexibility of any given political system. Where little by way of economic benefit is expected of government and/or where the populace is so cowed by its rulers that it dares not push for change, strong political reaction to economic hardships is less likely [redacted] 25X1 [redacted] 25X1 When governments can successfully deflect much of the blame from themselves onto less reachable targets—their predecessors, the bankers, the IMF, and so forth—they thus escape the fallout that can lead to serious political pressures or to political instability. [redacted] 25X1

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[redacted] The greatest likelihood of political instability arises when the sitting government is widely perceived as the main cause of the problems, as in the Philippines, where the Marcos regime plays such an enormous role in the nation's affairs. Likewise, the Nigerian Government is proving less and less able to deflect the blame away from itself, largely because the politically significant elites, particularly the military, have come to expect so many government benefits, the funds have dried up [redacted]

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Although most of the debtor countries are likely to begin a slow economic recovery this year or next, we think that their political resistance to austerity measures will build. As the shock of the financial emergencies of 1982-83 passes, and austerity measures are increasingly designed to restructure the economy to lay better foundations for future growth rather than simply to deal with the lack of foreign exchange, the necessity for sacrifices becomes less obvious, more debatable, and politically more difficult to implement.

Among the seven principal debtor countries that are having serious debt problems, *Brazil* probably is best placed to work itself out of its debt burden. Brazil is well positioned to sustain rapid and diversified export growth if it can keep its exchange rate competitive and if its foreign markets are expanding. Domestic political trends—a gradual process of democratization—reflect a broad public consensus and are unlikely to be upset even if the economy does poorly. But democratization does constrain the government's economic policy flexibility and consequently could lead to major problems in negotiations with foreign creditors. We expect the Brazilian Government to be able to continue a generally cooperative relationship with the IMF if external conditions permit economic recovery to proceed and the IMF continues to show flexibility. But, if external economic conditions turn sour and necessitate additional painful adjustment as political activity intensifies, Brazilian policy could quickly turn nationalistic and confrontational.

Mexico has made the most effective adjustment to the debt problem among all the major debtors. It has shifted from an enormous current account deficit to a large surplus, permitting a substantial buildup of foreign exchange reserves; it has also regained a degree of confidence among the banks, most of which have agreed to extend the period and ease the terms of rescheduling. Although it has started to recover, Mexico's economy remains depressed because austerity measures are restricting the public sector while low demand and lack of confidence have sapped the private sector. Strong leadership from President de la Madrid and effective use of the ruling party's organization have kept public dissatisfaction and political pressures under control. The government will not be able to tolerate for long, however, a

situation in which economic recovery is held up by lack of demand while foreign exchange reserves accumulate. Mexico is already beginning to expand the public sector once again, a process that if continued could lead to policy differences with the creditors. Moreover, during the remainder of his term, de la Madrid will face rising pressures for reforms in the political system even if healthy economic growth resumes. Although the ruling party—the PRI—has demonstrated considerable resiliency, there is a potential in the longer term for serious political instability to develop in Mexico—in the form of fragmentation of the PRI and growing opposition to the system—which would reduce the government's ability to negotiate constructively on matters of importance to the United States, such as trade, energy, and emigration, and could lead to serious domestic polarization and violence.

In *Argentina*, the inability of the political system to develop any sort of consensus on policy was the fundamental cause of poor economic performance in the past and will be the principal barrier to a resolution of the debt problem in the future. The Alfonsin government's dominant priority is to establish a democratic political system firmly in Argentina in hopes of eventually facilitating consensus. The nationalism, fractiousness, and impatience of the Argentines will make it difficult to forge such consensus, however, and hence impair the government's ability to implement conditions of the tentative IMF agreement. The difference between IMF criteria and what the Argentines can live with can probably be bridged, at least temporarily. There is a high risk of miscalculation, however, which over time could lead to a direct confrontation and perhaps to a breakdown of negotiations. The chances of such a breakdown are low, however, even though Argentina would be better able than other debtors to live with the consequences of default—its exports being readily marketable without identifying the source and some possibly shiftable to the USSR. Moreover, Argentina will almost certainly be unable to meet the conditions required by the IMF. Thus, debt crises will recur periodically. If interest rates do not increase and foreign demand for Argentine exports is strong, there is a reasonable chance that these crises will be worked out. In a less favorable external situation, or if the government appears to have been forced to take unpopular steps by its creditors, Argentina would soon be unable to service its debt.

Chile, despite having made perhaps the most painful adjustments among all the debtor countries, faces a severe foreign exchange

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constraint because its interest costs are growing more than its exports, which are depressed by low copper prices. The military government, although still able to impose its authority, has become more sensitive to public opinion as a result of recurrent public demonstrations and widespread discontent. It is following mildly expansionary economic policies, which, if they are continued and if external conditions do not soon improve, will put Chile out of conformity with the IMF conditions for loans. In any event, the political opposition to the Pinochet government (though badly split) is so widespread that it cannot be bought off by the limited economic carrots available to the government. And, if economic conditions do not improve, in the longer term, violent leftwing opposition may grow.

Although *Venezuela* is going through a fairly severe economic adjustment, it is buffered by a democratic political system that often results in weak governments but also in considerable stability in policies, by still substantial foreign exchange reserves, and by a high standard of living. The outlook is for continued economic stagnation, which could cause some erosion of political stability, but is unlikely to trigger major political upsets in the foreseeable future.

By contrast, *Nigeria* will continue to encounter highly unstable political conditions and probably have a series of military coups. Economic factors contribute to this instability—both the past oil boom, which fed enormous corruption, and the present economic depression, which is causing large-scale unemployment and declines in real wages—and conditions are unlikely to improve substantially in the next few years. Basic ethnic and regional rivalries and competition for a stagnant economic pie will be the major factors fueling this instability.

In contrast to the other major debtors, which have already made severe economic adjustments and whose economies have probably bottomed out, *the Philippines* began its economic adjustment to the debt problem only a few months ago and its economy is certain to decline substantially more before it hits bottom. The debt crisis is not the primary cause of President Marcos's political problems, but the economic recession is creating rallying points for the opposition. Even with an agreement with the IMF and debt restructuring, private sector confidence will remain low, and it is highly unlikely that Marcos can build a solid basis for future economic recovery. Moreover, as long as Marcos retains power he cannot deflect most of the blame from the system he established and controls. Thus, the potential for political instability in the Philippines is probably almost as high as in Nigeria over the next few years.

In general, we expect numerous conflicts between debtors and creditors during the next year or so. Rather than let these conflicts lead

to confrontation or ultimate default, debtors and creditors are likely to agree on various ad hoc arrangements to ease the debt service burden. Although there will be recurring crises and substantial arrears on payments of interest, it is unlikely, except under highly adverse international economic conditions, that any major debtor country will formally repudiate its obligations or be called in legal default.

Neither the debtors nor the creditors want to run the high risks default would entail. But these risks might appear acceptable if external conditions were unfavorable, especially for Argentina, which is less vulnerable to creditors' actions than many other debtors.

We believe that debtor-creditor conflicts will be ad hoc and bilateral. Debtor interests are too diverse to provide a basis for formation of any sort of cartel except under extremely unfavorable economic conditions, which might induce the largest debtors, Brazil and Mexico, to cooperate. However, consultation and communication among debtors will continue to grow, and political pressure on the creditor countries to give a higher priority to debtors' needs in their fiscal, monetary, trade, and aid policies will become far stronger.

This political pressure will come mostly from the so-called Cartagena Group of 11 Latin American debtors (including all the large debtors). We expect the Cartagena Group to work out common objectives, strategies, and tactics to use especially in international forums. Its major objectives include lower interest rates, open markets for LDC exports, some sort of cap on the debtors' interest burden, rescheduling repayments over long periods, and increased funding for international financial institutions. Agreement on such objectives, however, does not limit any debtor country's freedom of action and is unlikely to result in any joint actions on debt negotiations.

Even if, as we expect, major confrontations between debtors and creditors are avoided and workable compromises reached, the United States will continue to be blamed by many debtor governments for contributing to their problems. This political fallout from the debt problem will continue to complicate US relations with many of the Latin American debtors, which have high and sometimes unrealistic expectations of the US Government's ability to influence the IMF and the banks.